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TRANSPARENCY

Transparent Disclosure: A Movement Worth Noting

By Molly Doran and Jenn Cooney

In an effort to promote transparent disclosure practices—and further our core mission to represent the interests of readers of corporate disclosure—Labrador hosts the annual "Transparency Awards" as a way to recognize those that have made the effort to be transparent in their corporate disclosures and stakeholder communications. These "Transparency Awards" are unique in that winners in various categories are selected using objective criteria—237 discrete criteria that flesh out the five pillars of transparency (which will be applied by an independent "Transparency Scientific Committee" starting with the 2024 Awards process).

The set of 237 criteria flesh out the "Five Pillars of Transparency," which include:

1. **Accessibility.** Readers can quickly find pertinent information in a document and information is presented in a manner that is easy to digest.
2. **Precision.** The disclosure prioritizes thoughtful reporting and includes critical information beyond requirements of compliance that helps readers understand the company.
3. **Comparability.** Information is summarized appropriately and presented in a way that facilitates comparisons across companies and against readers' own guidelines, criteria and expectations.
4. **Availability.** Readers can easily find the document(s) they want in the format and language they need.
5. **Clarity.** Writing is in clear, plain language so that disclosures are immediately understood by the reader.

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The most transparent companies consider compliance a starting point rather than the destination. Stakeholder engagement and market awareness inform the communications approach, as does an interest in explaining, rather than merely disclosing, corporate decisions. The increase in voluntary or supplemental disclosure over the past few years is evidenced in the 2023 Transparency Awards results that just came out in September, particularly criteria aligned with the precision pillar.[1] Transparency award winners scored between 75-99 percent in this area, demonstrating exceptional knowledge of their reporting audience and prioritization of relevant content.

A significant driver of "beyond compliance" disclosure is in the context of company culture and broad-based performance factors, namely environmental, social, and governance (ESG). An understanding of purpose and values serves to bridge financial and operational objectives with ESG initiatives to develop long-term sustainable strategies. Companies now present their guiding ideals across documents to provide context for policies, practices, and strategic decisions. Within the S&P 250, values are presented in 74 percent and 58 percent of codes of conduct and ESG reports, respectively, and mission, vision or purpose is included in the introductory pages of 38 percent of proxy statements.

While sustainability and other ESG topics are woven into regulatory documents, such as 10-Ks and proxy statements, the primary reporting on these areas is found in ESG reports. Accordingly, we are pleased to add ESG reports to the Transparency Awards this year. With minimal regulatory requirements, disclosures in these reports are based almost entirely on voluntary reporting frameworks and feedback from stakeholders.

ESG reports provide an opportunity for companies to truly embrace transparency. While there was a wide range of results and overall scores, several criteria were met by approximately 90 percent of companies, including disclosure of year-over-year Scope 1 and 2 emissions data, discussion of giving back to communities and employee philanthropy, and inclusion of a section, subsection or callout for diversity, equity, and inclusion (DEI).

But transparent documents do not just provide more information; they say more in a way that feels like less. Legal and financial jargon is kept to a minimum, and visual elements are used strategically to help readers understand content, locate key information and draw comparisons. The presentation balances high-level summary information with compelling narrative and an appropriate number of details. The accessibility and comparability criteria aim to improve the reader experience. In 2023, proxy statements scores averaged 49 percent and 53 percent, ESG reports scored 40 percent and 40 percent, and 10-Ks scored 28 percent and 25 percent, respectively, across these areas.

In 2023, adjusting for the impact of the new ESG reporting category, we continue to see average scores rise, reflecting efforts across companies to be more transparent and build trust with stakeholders.

Transparency Key Highlights in 2023

In determining the "transparency awards," 250 companies were looked at using 237 discrete criteria, analyzed five documents, and collected 59,250 data points. The average transparency score was 46 percent. Exhibit 1 provides a graph of the transparency scores by document type over the last three years. ESG was first added in 2023.

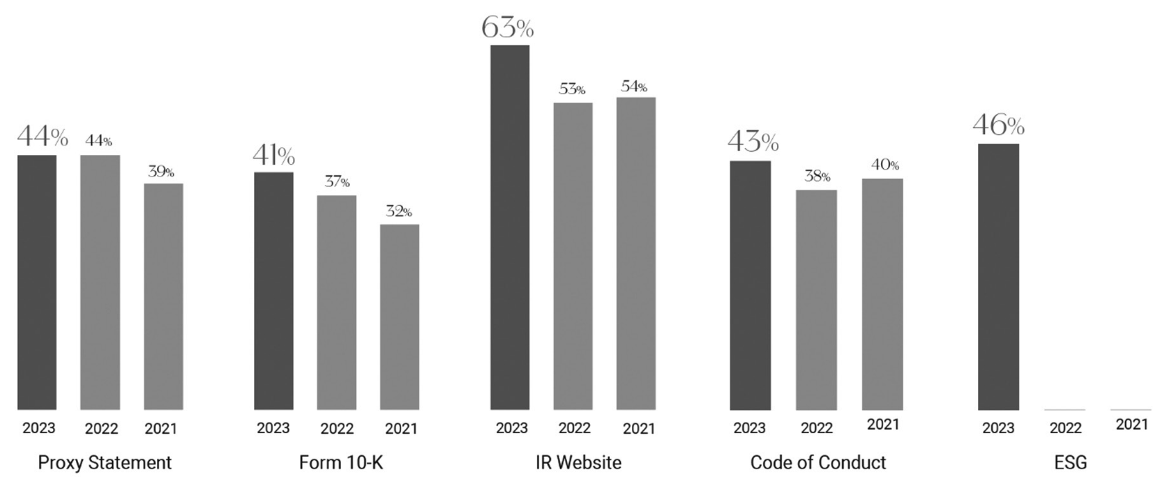
AQ: I created text in place of the small chart and the circle graph. Is this okay?

Each of the document types will be discussed in the remainder of the article.

Proxy Statement

The proxies of the S&P 250 averaged 103 pages in 2023. As proxy statements expand in content and stakeholder readership broadens, easy navigation is critical to allow readers to skip to topics of particular interest. Availability of documents in interactive

Exhibit 1—Evolution of Transparency Scores by Document Type



formats can assist the digital reader, and simple tables of contents provide direction within the document.

- 14 percent of companies provide an interactive version with links to navigate to and from sections of the document, including table of contents, up from 8 percent two years ago (2021).
- 48 percent have a table of contents that is one-page and includes two levels of hierarchy.

Letters from Leadership

Most disclosures in the proxy statement center around the Board of Directors, including Board composition, independent oversight, governance structure and processes, selection of auditors, and approval of executive compensation. Accordingly, highlights and themes of the proxy are presented best by, and in the words of, the Board.

32 percent include an introductory letter providing an overview of the board's priorities/focus areas from either independent board leadership or the full board. Letters were from:

- CEO only, 12 percent
- CEO and Chairman (being the same person), 34 percent
- Lead independent director, 26 percent
- CEO/Chairman and lead independent director, 17 percent
- Entire boards of director, 8 percent—up from 5 percent last year (2022)

Mission, Vision, Purpose

When underlying goals and objectives of the company are articulated, readers are in a better position to understand strategic decisions. Sharing motivational drivers also provides perspective on how performance may be evaluated, emphasizing that performance is not always limited to financial results.

- 38 percent present the mission, vision or purpose within the introductory pages.

Business and Financial Highlights

While the deep dive on company performance is presented in the 10-K, an overview of performance is appropriate for the proxy statement to provide readers with context for considering whether they agree with the strategic direction of the company as overseen by the Board (related to election of directors) and whether pay and performance is aligned (related to say on pay). Graphics used to highlight business/financial highlights in the company overview section was at 62 percent in 2023, 51percent in 2022, and 50 percent in 2021.

AQ: Again, I turned the bar graph into text. Okay?

ESG Highlights

With heightened interest in ESG, including from the investor community looking for confirmation that companies are evaluating ESG risks and opportunities, adopting sustainable business strategies, establishing appropriate goals and KPIs, and committing to regular ESG reporting, it has become standard practice to include an ESG highlights/summary section in proxy statements. In 2023, more than three-quarters of S&P 250 proxies included an ESG highlights section, averaging 3.4 pages. While these sections were prevalent, less than 15 percent included all of the elements to meet the transparency criteria.

78 percent include an ESG highlights/summary section.

- Location of ESG highlights:
  - 39 percent included in the introductory pages/Proxy Summary
  - 41 percent included in the Corporate Governance section
  - 23 percent included in a standalone section
- The ESG highlights/summary sections included:
  - 66 percent outlined ESG focus areas/priorities
  - 60 percent disclosed climate change/GHG/Net Zero goals
  - 52 percent stated environmental goals
  - 25 percent disclosed progress against goals
  - 55 percent provide a URL link to the latest report

Board Composition

Investors, as well as other stakeholders, are interested in assessing the composition of the board as a whole to ensure an appropriate balance of skills, expertise, and diversity, as well as evaluating each individual director. Disclosures need to demonstrate that the skillset of the Board is appropriate for overseeing the specific business and long-term strategy of the company. In addition to showing a thoughtful approach to director qualifications, readers expect companies to articulate their approach to Board diversity and to present demographics for accountability.

AQ: Converted graphic to text; okay?

While Stakeholders are interested in the skills and qualifications of the Board, they also want to know the relevance of each board skill and its link to company strategy. An individualized Board skills matrix was included in the proxy statement by 77 percent in 2023, 64 percent in 2022, and 45 percent in 2021. The relevance of each board skill was provided by 30 percent.

Board Diversity

56 percent have a dedicated section, subsection or callout explaining the company's approach to board diversity, including a policy or specific commitments.

- 76 percent explain approach to board diversity
- 62 percent state a policy or specific commitment to board diversity
- 8 percent specifically reference the "Rooney Rule"

87 percent present board diversity information (individual or aggregated) in a matrix or table.

- 51 percent present diversity information in the aggregate
- 56 percent present diversity information by individual director
- 54 percent include diversity information within the skills matrix

Governance

Two key themes of governance disclosures in the proxy statement revolve around: (1) demonstrating that the board, its leadership, and committee structure provide independent oversight apart from management; and (2) the board is actively engaged and effectively overseeing strategy, risk management, ESG, human capital management (HCM), and other critical matters to maximize long-term value creation.

Board Leadership Structure

56 percent explain the rationale and/or qualifications related to selection of individuals currently serving as chair and/or lead independent director.

- 19 percent include disclosure on the board's committee chair rotation and selection process.

Board Oversight

The document includes a dedicated section, subsection, or callout discussing the following board oversight responsibilities:

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- 50 percent strategy
- 57 percent information security (cybersecurity/data privacy) risks
- 46 percent HCM
- 83 percent ESG oversight

Note that 30 percent of S&P 250 companies are traded on Nasdaq and are subject to Nasdaq's diversity rules.

Distribution of Responsibilities

A matrix, table, graphic, or other visual element is used to depict:

- Distribution of specific risk oversight responsibilities among the Board, Board committees, and management, 63 percent—up from 43 percent (2022), and 35 percent (2021)
- Distribution of specific ESG responsibilities among the Board, Board committees, and management, 31 percent

Executive Compensation

Readers (and regulators!) expect robust executive compensation disclosures. Carefully crafted executive summaries provide an overview of the elements of compensation used in the program, including key terms of incentive programs, and also alert readers to key decisions, circumstances or prior say-on-pay concerns that might warrant a more in-depth review.

Tables, graphics, and other visuals consolidate information and break up dense text. Transparency, not just in terms of content, but also in presentation, is critical.

CD&A Executive Summary

Compensation discussion and a*nalysis* (CD&A) executive summaries include:

- Prior year say-on-pay voting results, 49 percent
- Changes to the program for the reporting year or statement that there are no changes from the prior year, 52 percent
- Overview of actual/paid compensation (for example, incentive payouts, discussion of pay for performance alignment or NEO scorecard/pay summary), 60 percent

Elements of Compensation

21 percent include components of a compensation matrix, table, or graphic that presents, at a minimum: the objective/purpose of each element; metrics and weighting used in incentive programs; and performance periods/vesting within the proxy summary or CD&A executive summary.

- Compensation components overview included:
  - Objective/purpose of each component, 76 percent
  - Metrics/performance measures used in each component, 61 percent
  - Weighting of each metric, 41 percent
  - Performance period and/or vesting, 41 percent
  - How element/component ties up to strategy, 29 percent
  - Callouts for new metrics/performance measures, 3 percent

Performance Metrics

- 75 percent explained the rationale for selection of performance metrics used in the annual incentive program for the applicable year.
- 66 percent explained the rationale for selection of performance metrics used in the long-term incentive program for the applicable year.

Pay versus Performance

- 84 percent included CEO pay ratio and pay versus performance in the Table of Contents (or a separate Executive Compensation Table of Contents).
  - Pay versus performance disclosure was an average of 3.8 pages.
  - 86 percent explained the relationship between compensation and performance using graphics.

Form 10-K

Overview of Strategy

As part of the business section of the proxy, companies are required each year to include material changes to their previously disclosed strategy. However, over the years it has become more common to remind readers of the key elements of the company's strategy and how it relates to strategic business initiatives. This helps to provide context for financial performance disclosures.

- 48 percent include an overview of the company's strategy in Item 1—Business.
- But only 15 percent include a graphic to highlight strategy.

Human Capital Management

The principles-based human capital disclosure requirement initially resulted in minimal reporting details following its enactment in 2020. However, Securities Exchange Commission (SEC) commentary and investor interest in understanding employee relations and risk has led to expanded qualitative disclosures and, to a lesser but still noticeable extent, quantitative information.

- Within the human capital management section there is a subsection on:
  - Diversity and inclusion, 90 percent—up from 83 percent (2022)
  - Employee recruitment and retention, 55 percent
  - Employee training and development, 84 percent

- — Employee health, wellness and safety, 74 percent
- — Culture and engagement, 66 percent—up from 50 percent (2022)
- The company discloses global workforce statistics on gender, 58 percent—up from 50 percent (2022)
- The company discloses workforce statistics on race, 46 percent—up from 39 percent (2022)

Risk

While waiting on SEC rulemaking last year on cybersecurity and climate change, most companies included disclosure on these topics from a risk perspective, with a significant jump in discussion of environmental risks.

- 96 percent discuss cybersecurity in the context of risk—down from 98 percent (2022)
- 80 percent discuss environmental issues in the context of risk—up from 65 percent (2022)

Investor Relations Website

Website Structure

The investor relations (IR) website is no longer solely focused on financial performance and required governance disclosures. Companies have realized that investors and other stakeholders want other information easily accessible, including background on the company and ESG information.

- 80 percent have a Company Overview or About section clearly identified and accessible from the IR homepage.
- 82 percent included a Sustainability or Corporate Responsibility section clearly identified and accessible from the IR webpage, up from 76 percent in 2022.

Annual Meeting Materials

In 2023, 72 percent of the S&P 250 companies held virtual annual meetings. As more of the process becomes digital, investors look online, reference the IR site more frequently and need quick access to information. Perhaps companies are hosting their meetings and related materials through other mediums as they finetune virtual meeting practices going forward, but despite an increase in need, consolidation of annual meeting information in one place on the IR website seems to have decreased.

- 32 percent have a dedicated website or landing page for the Annual Meeting that includes all materials needed for the AGM, down from 36 percent in 2022.
- 46 percent of IR sites offer easy and public access to the annual meeting webcast or transcript, down from 65 percent in 2022.

Earnings Presentation

Interest in reviewing recent company communications can help investors and other stakeholders understand key messaging. Most companies provide recent press releases and earnings materials, although easy access to the most recent earnings presentation has decreased.

- 85 percent of the "Investor" home page includes, at a minimum, "Events and Presentations," "Stock Information," and "Contact or FAQ," up from 82 percent in 2022.
- 83 percent provide access to view and download the company's latest earnings presentation, down from 92 percent in 2022.

Code of Conduct

Document Structure and Overview

With focus on ESG in recent years, and ESG reporting frameworks calling for disclosure of ethical practices, it follows that codes of conduct are starting to be more consistently reviewed and updated. Award results showed a significant jump in recently updated codes of conduct.

- 63 percent have a document dated and produced or updated within the last two years, up from 43 percent in 2022.

These documents continue to be drafted with intent to engage defined readers.

- 95 percent include a section about the purpose of the code and who it applies to.

Leadership Message and Values

Most companies include a letter from the CEO explaining why the policies and practices in the code of conduct are important to company culture and business, as well as setting expectations for strict compliance. This letter sets the tone from the top and is often found at the beginning of the document, along with an overview of cultural values.

Letter:

- 80 percent include a letter signed by the CEO, unchanged from 2022.
- 51 percent of the letters mention (i) the importance of ethics, compliance and integrity, (ii) following the code, and (iii) reporting a concern.

Values:

- 74 percent present the values at the beginning of the document, unchanged from 2022.

Ethics Oversight and Responsibilities

A strong ethics program needs not only Board oversight, but also a supporting governance structure. Award results show a modest increase in these disclosures, which is likely a result of expanded risk disclosures generally.

- 22 percent present the governance structure of the ethics and compliance program, up from 18 percent in 2022.

Ethical Reporting Guidance

Encouraging reporting of ethical concerns requires practical guidance and instructions. Fact patterns with guidance on how to handle the situation and Q&A formats are helpful. Codes of conduct also should have visual cues to easily locate key information and understand how to report a concern.

- 31 percent include a decisionmaking tree graphic, up from 25 percent in 2022
- 8 percent include a graphic depicting the reporting procedure, unchanged from 2022.

ESG

Reporting and Frameworks

ESG reporting is common practice today, with nearly all S&P 250 companies publishing an ESG report within the past two years. Further, there is widespread adoption of voluntary frameworks, standards and recommendations that guides companies to report on topics deemed "material" (defined in various ways depending on the analysis) to their business or industry, and also important to stakeholders.

- 99 percent of companies published a separate, stand-alone ESG (Sustainability or Corporate Responsibility) report annually or biannually.
- A high percentage of the S&P 250 voluntarily disclose information aligned with global reporting frameworks and standards:
  - Sustainability Accounting Standards Board (SASB)/International
  - Sustainability Standards Board (ISSB) Standards, 90 percent
  - Task Force on Climate-Related Financial Disclosures (TCFD) Recommendations, 82 percent
  - Global Reporting Initiative (GRI) Standards, 76 percent
- 67 percent of companies' ESG goals and/or initiatives are aligned with UN sustainable development goals.

Leadership Message

Letters from leadership set the tone for the ESG report and emphasize that senior management is committed to the company's ESG priorities. Typically from the CEO, this is an opportunity to communicate the role sustainability plays in strategy setting, risk management, and company culture. An opening letter also is used to add narrative around specific initiatives and emphasize recent accomplishments. Some companies choose to include messaging from other senior leaders with significant ESG responsibilities, which usually supplements the introductory letter.

- 67 percent include an introductory letter discussing how ESG is integrated into company strategy from either the CEO, the Board or Chief Sustainability Officer (or equivalent).
- Letters included:
  - Chief Executive Officer, 90 percent
  - Sustainability management, 22 percent

- 40 companies had additional letters from members of the leadership team, including the Chief Financial Officer, Chief People Officer, General Counsel and Lead Independent Director.

Overview of Priority Topics

A key disclosure in ESG reports is the explanation of how the company evaluated and prioritized ESG topics most relevant to the business. Sometimes called a "materiality assessment" or "impact assessment," readers expect a summary of this process and its outcomes. This helps to understand the goals and objectives set by the company and how they align with long-term strategy. Given the length and breadth of ESG reports, most companies include a 1 or 2 page ESG highlights section early on in their reports where readers can quickly distill these priorities and the associated progress or performance throughout the course of the year. A successful summary demonstrates the company's progress toward goals and highest priority topics in a visually engaging and useful manner.

- 43 percent disclose an overview of ESG "materiality" including how "material" ESG topics were determined and prioritized.
- 71 percent include a summary of ESG commitments/highlights within the introductory pages.

Climate and Climate Risk

Given the uncertain state of climate science and policy globally, stakeholders in recent years have sought more detailed disclosures on how companies are managing their climate risks and opportunities. It has become standard best practice for public companies to disclose information following TCFD recommendations, which focus on governance, strategy, risk management, and metrics and targets. The SEC's pending climate disclosure rules is based in part on TCFD recommendations, and the rule incorporates TCFD's four pillars.

Governance, Strategy and Risk Management:

- 71 percent discuss the board's role in oversight of climate risks and opportunities.
- 70 percent explain how the company identifies, prioritizes and manages climate risks and opportunities.

Metrics and Targets:

- 92 percent report year-over-year Scope 1 and 2 emissions data (unless publishing an inaugural report).
- 77 percent report Scope 3 emissions data for the reporting year.
- 56 percent of greenhouse gas/carbon emissions reduction targets are quantitatively disclosed.
- 38 percent of the greenhouse gas emission targets are approved by the Science-Based Targets Initiative (SBTi).

Assurance:

- 58 percent provide a third-party assurance/verification letter(s) for GHG emissions data.

DEI and Workforce Statistics

DEI is an ESG issue covered in almost all ESG reports. Disclosure of policies and initiatives are common, but the importance of data to show accountability cannot be overlooked. While workforce data increasingly is disclosed in 10-Ks, more granular data is expected in ESG reports and the most transparent companies present, in graphic form, diversity at various levels of the organization. The interest in data is apparent in the push by stakeholders for companies to release EEO-1 data.

- 20 percent include graphics to represent gender at the board, senior leadership and associate levels
  - Board level, 47 percent
  - Senior Leadership, 46 percent
  - Associate level, 31 percent
- 18 percent include graphics to represent race/ethnicity at board, senior leadership and associate levels.
  - Board level, 44 percent
  - Senior Leadership, 41 percent
  - Associate level, 29 percent
- 49 percent of companies provide a link to their latest EEO-1 report.

Cybersecurity

Anticipating new rules from the SEC (adopted in late July 2023) and listening to stakeholders express interest in information security practices, many companies have included voluntary disclosure in their ESG reports. Only about half of companies meet the various transparency criteria. Overall, a sharp increase in content will be required when the new rules covering cybersecurity risk management, strategy and governance become effective for reporting in the Form 10-K.

- 76 percent of companies describe its overall strategy and policies relating to information security (cyber/data privacy).

Related cybersecurity disclosure includes:

- Board's role in oversight of information security (cyber/data privacy), 52 percent
- Whether company has a Chief Information Security Officer or similarly titled position, 54 percent
- Monitoring and mitigation policies and practices, 51 percent
- Alignment with national or international standards like NIST or ISO, 54 percent
- Cybersecurity training, including who is trained and how often, 45 percent

Other ESG Topics

While ESG issues vary by company, some topics are considered universally applicable and are expected to be discussed in reports, even if only to explain why the topic is not material to the company.

Board Oversight of ESG:

- 81 percent discuss the role of the board in ESG oversight, including which board committees oversee the company's highest priority ESG topics.

Risk Management:

- 31 percent of companies explain how their enterprise risk management (ERM) process includes the assessment/evaluation of ESG topics.

Human Capital Management:

There is a section or subsection on:

- Recruiting and retention strategies, 52 percent
- Employee training and development, 86 percent
- Employee health and safety, 80 percent
- Employee wellness, well-being or mental health, 71 percent
- Employee engagement, 82 percent

Human Rights:

- 71 percent include an overview of the company's strategy and commitment to human rights.

Supplier Expectations:

- 66 percent provide a link or summary of the company's supplier code of conduct.

Community Engagement:

- 89 percent discuss giving back to communities in which the company does business or employees live.
- 39 percent explain how community engagement is tied to ESG goals and broader business purpose and strategy.

Note

1. The Award winners are listed on *https://www.transparencyawards.com/*.

The Case for Increased Corporate Disclosure: An Examination of Transparency, Trust and Taxonomy

By Rachael Doubledee, Matthew Nestler, and Kelley-Frances Fenelon

An array of standard setters, raters, and advisors have emerged in response to increasing awareness of what some refer to as "nonfinancial factors" in company performance. Corporate disclosures have been broadly categorized into "financial" and "nonfinancial," but this distinction is somewhat misleading.[1] In reality, companies navigate systems of interconnected contexts (from community impacts to worker advancement) to create value for consumers, employees, and shareholders.

Ignoring workforce and community impacts to focus only on traditional financial factors means ignoring the larger palette in favor of one color, painting an incomplete picture of company value creation, cost, and risk.[2] Stakeholders are increasingly demanding transparent and comparable disclosures that represent a more holistic assessment of company performance. Lacking a complete picture, companies, investors, and other stakeholders like employees, communities, and customers are unable to fully evaluate company performance and make informed decisions.

Environmental disclosures are becoming standardized, but workforce and community impact disclosures are less so, especially in the United States. At the same time, elevated inflation, a tight labor market, attendant competition for talent, and shifting expectations from younger generations underscore the importance of workers and an organization's community interactions in sustaining operational success.[3] As stakeholders increasingly expect meaningful and transparent disclosure, companies are looking for clarity on what metrics to report and how to report them.

This article focuses on understanding how the US public perceives and prioritizes transparency in corporate disclosures and examines alignment with the public's expectations for corporate transparency and corporate disclosure on key workforce topics. This framing is essential: The public drives perception of corporate reputation and brand loyalty and is composed of key stakeholders who impact company valuation, including consumers, investors, and workers.[4]

The American Public Wants More Corporate Transparency

Large majorities of US citizens, across demographic groups and the political spectrum, want improved transparency and disclosure from the United States's largest public companies.[5] One survey found that 85 percent of people agree that companies should disclose more about their business practices, including their environmental (94 percent) and societal (86 percent) impact.[6]

In another survey, 93 percent of people in the United States favored large companies publicly releasing the wage ranges for various types of jobs at their company, and this finding held across the political spectrum, favored by 95 percent of Democrats, 91 percent of Independents, and 94 percent of Republicans.[7] Similar bipartisan consensus was found among the 89 percent of respondents who favored the release of minimum wage

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rates for frontline and entry-level workers (94 percent Democrats, 87 percent Independents, 87 percent Republicans).[8]

Our company conducts yearly focus groups in the United States. Participants are recruited to ensure representation by key stakeholders, such as workers at large companies, and across demographic groups and political affiliations. It is important to keep in mind that workers are also consumers and shareholders, and they often bring that lens to discussions.[9]

Last year, we conducted six focus groups, each containing seven participants and a moderator, to discuss topics related to just business behavior by the largest public corporations in the United States. Inductive thematic analysis revealed four main themes around transparent disclosure: (1) accessibility of information; (2) disclosure of missteps; (3) trust and follow-through; and (4) responsibility to society.[10]

Participants said that honest, transparent disclosures affect how positively or negatively consumers and shareholders value the company and that they expect large public corporations to follow through on commitments and statements. Studies have shown that greater corporate transparency results in higher levels of customer trust and brand loyalty.[11]

Accessible, Honest Disclosures

Five out of six focus groups explicitly stated that companies should disclose honestly, in good faith, and in more detail than required by regulatory mandates. Participants consistently noted that some disclosure was better than none, and more was better than less.

Disclosures written in accessible language and formats are considered the most transparent. As one participant said, disclosure should be written in a way that "the average Joe can look at it in bullet points and say, 'These are the main points.'" Similarly, clear disclosure should include comparable standards. One person said, "Telling us how many gallons doesn't put into perspective what other companies use and what the standard is. There's got to be some level metric to delineate whether or not it's good or bad. I think more transparency with all that would be better."

Participants said accurate and contextual information should be provided to avoid the appearance of being misleading. As one participant put it, "So just saying we want to require them to report, this doesn't necessarily mean that the information that they're required to report is good. It just means that they reported it. I think proper plain context should be required, rather than just a reportability requirement."

Disclose When You Mess Up

All six focus groups agreed that companies should disclose the bad with the good and not try to hide missteps. As one participant put it: "If you're doing something evil, at least you told us, so we know." Interestingly, there also was a perceived upside in disclosing such incidents: Disclosing the bad with the good made a company's good statements more believable.

When risk incidents occur, participants said companies should act quickly and disclose remedial plans clearly in an effort to "be transparent with what's happened, to what's going on. So as things occur, say, 'Yeah, hey, we [messed] this up. That's on us. And this is what we're doing to recover from this, to repair the damage we caused.'" Failure to disclose missteps was perceived as "shady" by participants.

Most focus groups were understanding of mishaps and thought companies should be allowed to recover from mistakes. One woman said: "You can do bad things; just like humans, we make mistakes, so we can't just keep them at fault." However, participants wanted to see willingness to do better and learn from mistakes, with one noting that if companies were "not willing to fix themselves, then that's an issue." Disclosure of a clear plan can foster public trust and is seen as less risky than attempting to keep mistakes under wraps.

Transparency Equals Trust

Five out of six focus groups connected transparency to trust and confidence in a business.

Participants made it clear that if a company was not transparent, the public trusted the company less. Participants also said if they had a choice between a more transparent and a less transparent company, they would do business with the more transparent company. As one person put it, "If I can't trust you, I'm not dealing with you."

Absent or bare-minimum corporate disclosure was perceived as "likely hiding something." The risks of disclosing only the bare minimum required is considered reputational, but participants said it could also negatively affect company value. Some noted that companies that only disclose the bare minimum risk being "left behind" by peer companies that disclose more information.

One participant said: "When I think about the companies that have said something versus the ones that haven't, it's not a good look for the ones that haven't. The fact that they haven't said anything, or when they do it's just like bare minimum, has definitely given them a negative reputation versus the other companies that have said something."

Being proactive (rather than reacting to public pressure) and following through on commitments enhance trust in corporate statements. Participants said they want disclosures that allow them to "see [a company's] vision for society and their communities," so they can "maybe not necessarily hold them accountable but understand that they have a vision to begin with and then see how they progress with that vision year after year."

Participants struggled to trust statements made by large companies if they did not follow through on commitments. Many viewed statements without clear actions and goals as performative. Although this theme emerged in many discussions, it was consistently reiterated when participants were asked if companies had followed through on recent diversity commitments. Many said that inclusion efforts were either not well publicized by companies or not clearly disclosed, and most did not believe that companies were making progress, dismissing the possibility with "not that I've really seen."

Transparent, Honest Disclosure: A Responsibility to Society

Americans believe that large public companies have a responsibility to society to be transparent and to communicate honestly about policies and practices; four of the six focus groups discussed transparency as a "duty" or a "responsibility" of the firm. When asked what responsibilities large corporations have to society, transparency was often listed by participants. One man said, "They need to communicate the truth about their business, be honest with the public and their consumers, their stakeholders. I like transparency, and I wouldn't want to be led to think one thing and the company be doing something else."

Participants view public, transparent disclosure as a bare-minimum obligation that companies have to employees, customers, communities, and shareholders. Because transparency is linked to customer trust and brand loyalty, and thus company performance, companies can gain an edge on competitors by putting these principles into practice.

Disclosure Among America's Largest Public Companies Is Low

Our focus groups show that the American public seeks transparency, yet disclosure by the largest public companies falls short on workforce, job-quality, and equity topics. Our JUST Jobs Scorecard evaluates companies on 28 job-quality indicators. Exhibit 1 shows that nearly half of all indicators have a disclosure rate of less than 20 percent, 20 out of 28 indicators have a disclosure rate between 0 percent–40 percent, and no indicators have disclosure rates between 80 percent–100 percent in Russell 1000 companies.[12]

This pattern of low disclosure is hardly new. In a 2021 study, we evaluated the state of disclosure by the 100 largest publicly traded US employers on 28 human capital topics, finding that 23 out of the 28 metrics had a disclosure rate below 20 percent, five between 20 percent–40 percent, and just one between 40 percent–60 percent.[13]

Exhibit 1—Job-Quality Disclosure Rates in Russell 1000 Companies

DISCLOSURE RATE	JOB-QUALITY INDICATORS (n=28)
0%-20%	12
20%-40%	8
40%-60%	5
60%-80%	3
80%-100%	0

Source: JUST Capital

Similarly, our 2022 Racial Equity Tracker's evaluation of equity disclosures by the 100 largest publicly traded US employers found disclosure was low on many topics, including less than 10 percent disclosure of internal hire or promotion rate by race/ethnicity, local supplier/small business spend amount, and reentry or second-chance policies.[14] Because larger companies tend to disclose at higher rates compared to smaller companies, low disclosure in the largest 100 publicly traded US employers suggests that smaller companies have even lower rates.[15]

There have been some improvements. For example, the share of Russell 1000 companies that publicly disclosed the gold standard for workforce demographic disclosure (the EEO-1 report)[16] or similar intersectional data more than tripled from September 2021 to September 2022, from 11 percent to 34 percent.[17] Likewise, the share of Russell 1000 companies disclosing a gender pay gap analysis grew from 23 percent to 32 percent over the same period.[18] These improvements demonstrate a willingness to clearly and transparently communicate performance, especially when given clear disclosure guidelines.

How to Meaningfully Communicate Corporate Impact on People and Communities

Employees, customers, shareholders, and other stakeholders share a desire to be better informed about the products and services they use. Business leaders can take the following steps to meaningfully communicate corporate impacts on people and communities. First, effectively organize information for the intended audience and clearly communicate the strategic purpose. Second, determine the scope of the disclosure based on the audience's needs and what the company is comfortable disclosing. Third, provide contextual information to make disclosures accessible and comparable to stakeholders.

Effectively Organize Information and Clearly Communicate Strategic Purpose

To clearly communicate disclosures based on the intended stakeholder audience, companies can use taxonomies to align information with stakeholder objectives in a more digestible way. This kind of framing provides structure and focuses the messaging, helping stakeholders better interpret disclosed information.

Companies can use such taxonomies to cut through details and draw important analytical distinctions. For example, in the Racial Equity Tracker, we categorize corporate disclosures as either "commitment" or "action." We provide a clear definition for each category, defining commitment as "a statement or generic policy that notes that a company is committed to a certain element of anti-discrimination or inclusion" and action as "a program, disclosure or policy that shows progress of accountability toward a commitment or one that has an immediate impact."[19]

Similarly, in a 2022 analysis of workplace and human capital policies, we categorized items as "policy" or "performance." The former referred to "whether companies disclosed the presence or absence of corporate workplace and human capital policies," and the latter "[evaluated corporate] performance on these issues." The latter can be understood as more detailed, evaluative, and transparent disclosure.

These distinctions draw a line from the underlying information to the larger messaging around how companies are performing on racial equity commitments and workplace and human capital policies. Companies can adopt similar taxonomies to include more information while providing a focused throughline that helps stakeholders accurately assess performance.

Determine the Scope

Companies should determine the scope of their disclosures by balancing operational objectives with meaningful, transparent information for stakeholders. Whenever a company can disclose more details, especially in regard to actions or policies that directly impact stakeholders, it should. These details make disclosure more meaningful for stakeholders.

In workforce and job-quality metrics, disclosing the details of a policy often provides more valuable information than simply disclosing whether the company has a policy.

Consider the example of paid parental leave. Some companies disclose only that they provide paid parental leave to employees. Other companies disclose both the paid parental leave policy and the number of weeks provided for various types of caregivers and employee classifications. The latter conveys more useful information to help stakeholders evaluate how competitive a company is in the labor market.

Including various types of disclosures with several levels of detail helps capture company performance and make disclosures more comparable, especially when companies can't disclose more information due to legal risks.

This is well illustrated in our recent analysis of Russell 1000 companies' performance on gender pay gap analyses. We assessed both disclosure of a gender pay gap analysis, and, if reported, the adjusted women-to-men pay ratio at the company. We found that although 32 percent of Russell 1000 companies (302 companies) say they conducted a gender pay gap analysis, only 14 percent (130 companies) disclose the pay ratio.[20] Of the 130 companies that disclose a pay ratio, nearly all reported a ratio at or near gender parity (1:1).[21]

Having both metrics allows us to more accurately interpret the data. If we had only considered the adjusted women-to-men pay ratio disclosure, we would have concluded that although disclosure was low, nearly all companies have small, if any, gender pay gaps. Capturing the pay gap analysis disclosure led us to conclude that companies may not disclose results that reveal they are not near parity.

Although disclosing less may seem prudent, the public understands that companies are continuously improving. In the absence of disclosing direct results, companies should remember that some information is better than none. Disclosing clear roadmaps and goals lets stakeholders see the color palette even when the full painting is not yet ready to be displayed.

Add Context to Make Information Accessible

Companies should ensure that disclosures provide contextual information that makes them easily understood by stakeholders and comparable across similar companies. For example, in a disclosure about paid-leave policies, companies could provide details about which employees the policy applies to (for example, full time, part time, temporary, gig), whether it is limited by geographic location, and whether it applies on the first day of employment or requires tenure.

For disclosures of quantitative metrics, such as turnover rate, companies should consider providing context. For example, if a relatively higher turnover rate is a part of a company's business strategy, it may be beneficial to communicate that information so stakeholders can more accurately interpret the statistic.

Done mindfully, corporate disclosure is an opportunity for companies to demonstrate to stakeholders the value they add not only in products or services, but in the lives of workers and the communities where they operate—understanding that the two are intertwined. In good times, it is a space to invite stakeholders to share in visions and plans for the future. In difficult times, it is a space for companies to provide context to decisions and disclose clear goals and plans that show they are more than their mistakes.

Future Directions

Over the last decade, it has become clear that traditional financial disclosures do not represent a complete picture of company performance; financial outcomes are inseparably fused to workforce and community impacts and actions.

We expect transparent disclosure of corporate impacts on workers and communities to continue to be a priority for multiple stakeholders, including the American public, investors, and regulatory bodies like the US Securities and Exchange Commission (SEC). Increasing global attention to transparent disclosures will bring pressure from regulatory bodies for companies to disclose new quantitative and qualitative information clearly, consistently, and in a way that allows for benchmarking and comparison.

Although the United States may be slow to enact standards, many US companies will be impacted by the Corporate Sustainability Reporting Directive requirements the European Union will implement in a phased approach over the next few years.[22] This framework will require companies to assess both past actions and future goals, as well as independent auditing plans.

As disclosure of workforce and community impact factors are increasingly regulated, the largest companies will likely adopt consistent and comparable disclosures and model clearer best-practice standards for other companies to follow. Similar practice diffusion can be expected across key metrics that are not required, but where consensus from stakeholders advocating for disclosure nevertheless exists.

For example, the United Kingdom's requirement of gender pay gap reporting for companies with more than 250 employees has prompted pay gap analyses by multinational corporations across employees in other countries and created an expectation among investors and other stakeholders that companies implement and disclose such analyses.[23] Stakeholder demand also has led to a significant uptick in the public disclosure of EEO-1 workforce demographic data, a step not legally required of companies. Pressures from both stakeholders and regulatory bodies indicate that companies should prepare to disclose more across a range of topics.

The key themes and perspectives highlighted in this article indicate a path forward to develop more comprehensive disclosures and help companies recognize how to expand their palette in an effort to paint a more complete picture.

Notes

1. Some use the term "human capital" to capture topics associated with "nonfinancial factors," but both of these terms obscure the fact that investors consider topics such as workforce cost and turnover as being financially material. To avoid using terms that mean different things in different fields, in this article, we talk about "workforce and community impact" metrics and disclosures. We define these as topics that entail material risks and opportunities to companies.

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16. Companies with 100 or more employees in the United States are legally required to submit the EEO-1 report to the US Equal Opportunity Commission and Department of Labor (though not to publicly disclose). This includes Component 1, which shows workforce demographics by race, ethnicity, and gender by 10 standardized job categories; *see* "EEO-1 Data Collection," US Equal Employment Opportunity Commission, accessed July 2023 at *https://www.eeoc.gov/data/eeo-1-data-collection*.
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20. Indeed, we found that disclosure of the performance data points was even lower than policy data points.
21. Nestler et al., *supra* n.18.
22. These requirements will mandate that companies publicly report nonfinancial information detailing impacts on people and the environment. Although 2024 compliance will only impact EU companies with over 250 employees and an annual turnover more than US $43 million, these provisions will also eventually apply to some of the largest non-EU companies who do business within the European Union; EU companies with an annual turnover that exceeds $163 million will also be expected to comply, with a few exceptions.
23. Schlager, Tobias, *et al.*, "Research: Customers Will Reward Companies for Smaller Gender Pay Gaps," *Harvard Business Review*, November 15, 2021 at *https://hbr.org/2021/11/research-customers-will-reward-companies-for-smaller-gender-pay-gaps*.

CYBERSECURITY

A Deep Dive into the SEC's Materiality Trigger for Cybersecurity Incident Disclosures

By Andrew Pak and Rebecca Engrav

The US Securities and Exchange Commission (SEC) adopted final rules relating to cybersecurity disclosure on July 26, 2023, which will take effect on December 18, 2023. The new rule requires public companies to disclose material cybersecurity incidents and to make affirmative representations relating to the organization's cybersecurity risk management, strategy, and governance in annual reports.[1]

As companies brace themselves for the SEC's new disclosure requirement, we offer a closer look at the SEC's "materiality" standard as it applies to cybersecurity incidents. Some organizations may need to make significant adjustments into how incidents are handled and assessed in order to meet the fairly strict timelines for disclosure. We expect that properly and accurately assessing the materiality of a given incident will be a complex endeavor, fraught with legal risk.

The Materiality Trigger

As set forth in the SEC's initial proposal and reaffirmed in its publication of the final amendments, cybersecurity incidents trigger the new disclosure requirements when the incident is "material." An incident is "material" when the relevant information—that is, the description of the incident itself—is information for which there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision, or when it would have significantly altered the "total mix" of information made available.

These are familiar standards for any public company in the abstract, but will now be applied in a field so new and dynamic that even the SEC has declined to offer a definition of it in the rule. (As noted in the SEC's adopting release: "We also decline to separately define "cybersecurity," as suggested by some commenters. We do not believe such further definition is necessary, given the broad understanding of this term. To that end, we note that the cybersecurity industry itself appears not to have settled on an exact definition, and because the field is quickly evolving and is expected to continue to evolve over time, any definition codified in regulation could soon become stale as technology develops.").[2]

Indeed, the SEC explicitly declined to adopt a cybersecurity-specific definition of "materiality," instead noting that "[c]arving out a cybersecurity-specific materiality definition would mark a significant departure from current practice, and would not be consistent with the intent of the final rules." If the materiality call is close, the SEC advises erring on the side of disclosure, noting that "[d]oubts as to the critical nature of the relevant information should be resolved in favor of those the statute is designed to protect, namely investors." (Footnotes and citations omitted.)

Incident responders tend to think of the "significance" of an incident in terms of one or more of the following: (1) the quantity and quality of data that was accessed (with a focus on the risk of harm to the data subject for an unauthorized disclosure); (2) the level of operational disruption imposed; and/or (3) the existential risk to the company itself. What the SEC's comments make clear, is that these avenues

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for assessing significance are only some of the ways an incident can be "material." Below, we discuss how the SEC's concept of "materiality" adds new considerations that incident responders, and those engaging with them, may not be in the practice of incorporating. Following that, we discuss some potential pain points in assessing materiality for events that are otherwise "significant" under the more traditional approach to assessing incident severity.

Additional Signals That an Incident Is Material: A Different Type of Harm

The SEC's comments illustrate that the focus of any materiality assessment should be "through the lens of the reasonable investor." In other words, materiality is not limited to a quantifiable amount of access that occurred, or how likely it is that such access would affect consumers, but includes any information connected to an incident that a reasonable investor would want to be aware of, or that would otherwise significantly alter the "total mix" of available information.

So, while incident responders may typically think of the risk of incident-related harm as the risk that a bad actor might misuse the information to the detriment of data subjects, harm in this context can mean selling a "cybersecurity bill of goods" to the reasonable investor.

This means that certain events, even if the specific occurrence does not seem especially significant or harmful, may still be viewed as harming potential *investors* if the incident is evidence of bad security practices in general. In other words, if an incident reveals a weakness in an organization's security safeguards, but the organization "got lucky" in the incident itself, that "luckiness" does not absolve it of the need to assess whether the weaknesses demonstrated are material when considered more holistically.

A good analogy for this concept is childcare. Imagine that you drop your child off every day for daycare. There is an incident where your child is struck by another child in the presence of daycare staff, who immediately address the issue, called you, and explained the whole situation, why it happened, and what they will do to avoid a future incident. I think we would all expect and demand that. What if, the next day, your child was alone in the same room with that child for 30 minutes, and during that time, the other child threw something heavy at your child, and completely missed.

No staff members were present because the childcare center had an insufficient number of professionals on duty, and their practice is to remain open even if understaffed. Material? Wouldn't you as a parent want to be notified of an incident, even though there were no injuries, given that the incident demonstrates a general level of care well below what you expected and paid for? Ultimately, the harm to the parent from the second incident is analogous to the concept of harm inherent to the SEC's "materiality" trigger.

A real world example worth examining is the securities litigation arising out of the widely publicized breach of SolarWinds Corporation's (SolarWinds) ubiquitous network monitoring tool, Orion. This theft of data from SolarWinds and its customers (the Orion Breach) is considered to be a "supply-chain" attack because the malicious hackers targeted SolarWinds primarily to reach their downstream customers.

In the litigation arising out of the Orion Breach, a federal district court considered SolarWinds' motion to dismiss a class action complaint from a class of plaintiffs who purchased SolarWinds securities from October 18, 2018, through December 17, 2020 (a time period leading up to the late 2020 discovery of the breach).[3] The plaintiffs alleged that the defendants (including SolarWinds, its CEO, CFO, and Vice President of Security Architecture during the class period, as well as two private equity firms each holding approximately 40 percent of SolarWinds' stock) made material misrepresentations about their cybersecurity during this time period.

One of the many representations the plaintiffs complained of were representations by SolarWinds that it maintained a password policy on which employees were trained and with which they complied. This representation was juxtaposed against another incident that was not at all related to the actual Orion Breach and was not found to be associated with the theft of data, but which nevertheless occurred during the relevant time period.

On November 11, 2019, SolarWinds was notified in writing that a cybersecurity researcher was able to find a password for the update server SolarWinds uses to distribute software updates for its Orion product; that the password was available for approximately one-and-a-half years on GitHub; and that the password itself, "solarwinds123," was incredibly weak. The defendants argued that their prior touting of their cybersecurity posture and practices are not rendered materially misleading simply because they were ultimately breached.

The court recognized the accuracy of this argument, but went on to note that the basis for the court's materiality finding is premised differently, as it is based on "separate facts [alleged by the plaintiffs] that the cybersecurity measures at the company were not as they were portrayed, such as the 'solarwinds123' password incident …." Ultimately, the court largely denied the defendants' motion to dismiss, finding that plaintiffs had adequately alleged, *inter alia*, actionable and material misstatements. In other words, in light of affirmative statements the corporation made about its security, the "solarwinds123" incident was found to be plausibly "material," because it arguably showed that "the cybersecurity measures at the company were not as they were portrayed…"

Counsel who are familiar with the Federal Trade Commission's (FTC) approach for assessing data security issues will see parallels. Although the FTC focuses on consumers rather than investors, the issue of whether a security incident calls into question the accuracy of an organization's description of its security practices or its response to an incident, even in the absence of significant harm in fact arising from the incident, is a core component of the analysis under both legal regimes.

What the *SolarWinds* opinion shows is how the concept of materiality to investors can be applied to cybersecurity incidents. And while incidents that would traditionally have been viewed as "significant" for a company would almost certainly be considered "material," information about an incident can also be considered "material" simply because it shows that an organization is not as serious about cybersecurity as it otherwise claims to be. Keep in mind that a primary purpose of the SEC is to prevent unfair asymmetries of information, not to implement good cybersecurity.

So, while incident responders traditionally think about sizing an incident based on the "harm" done to an organization, its data, or others, materiality requires companies to assess these same incidents, but with a view to preventing the "harm" to an investor paying for the stock of a company with good security (or security as represented in public statements), while receiving the stock of a company with bad security. Although it remains to be seen exactly how the case law around this issue will play out, the reality is that plaintiffs need only generate a genuine dispute of material fact in order to get to a jury or bench trial.

Pain Points in Determining Whether an Incident Is Material

Materiality assessments need to be adequately conducted, which can be tricky in any context. Remember, the new rule not only requires that material incidents be disclosed, but also that all material aspects or details of the incident are disclosed. Proper disclosure requires careful coordination between stakeholders and attorneys who are well versed in the SEC's "materiality" standard, as well as with frontline incident responders with a firm grasp of the evolving factual understanding of a given incident. Regulators view an organization as a holistic unit, and expect such collaboration to be effective, even though the reality is that a significant amount of information can be lost in translation.

An SEC enforcement action related to a failure in First American Financial Corporation's (First American) disclosure controls and procedures helps to illustrate this point.[4] In June 2021, the SEC issued a cease-and-desist order and levied a fine against First American for failing to properly assess the quality of its disclosure relating to a cybersecurity incident. The core of the allegations relate to a failure in First American's process for assessing the need for a cybersecurity incident-related disclosure, as opposed to the ultimate content of their disclosure. The incident itself involved First American's "EaglePro" application, which was used to share document images related to title and escrow transactions. The EaglePro application lacked any real form of security since 2003 over a subset of documents stored there.

For these documents, many containing sensitive financial information, the only "security" applied was the use of URLs that included a sequentially assigned numerical code that would increase by one for every new document stored in the application. This would mean that anyone that had one of these URLs could simply change the associated number and see someone else's closing documents. While this vulnerability had existed since 2003, a cybersecurity journalist disclosed the vulnerability to First American on May 24, 2019. First American filed a Form 8-K four days later, with the following description: "First American Financial Corporation advises that it shut down external access to a production environment with a reported design defect that created the potential for unauthorized access to customer data."

You may be asking yourself, if First American disclosed the incident, what could possibly be the problem? The SEC noted that First American personnel had discovered this vulnerability back in January of 2019, and even scheduled its remediation pursuant to its own vulnerability management policy. However, for whatever reason, that remediation was never completed. The SEC's stated concern was that the senior executives responsible for filing the Form 8-K statement describing the incident "lacked certain information to fully evaluate the company's cybersecurity responsiveness and the magnitude of the risk from the … vulnerability at the time they approved the company's disclosures."

In other words, the SEC had certain expectations as to how in-depth, and effective, diligence surrounding a disclosure statement needed to be, and found First American's process here lacking. What was missing was an assessment of the fact that the vulnerability had been known to the company for approximately five months prior to the incident, but it had not remediated the known issue in violation of its own policies. While the SEC did not go as far as saying that this fact needed to be in the Form 8-K disclosure, it did make clear that it was a violation for the senior executives responsible for drafting the disclosure to not have been aware of that fact.

Accordingly, it is crucially important for businesses to put in place sufficient processes to ensure that (1) potentially material incidents are assessed by legal counsel, and (2) that counsel can engage with the investigation beyond a summary of findings to date, in an effort to identify all of the ways it can later be viewed as "material."

Practical Tips

1. **Identify, assess, and manage all your representations about security.** As noted above, the delta between what your organization represents about its security, and what an incident says about that representation, is one of the ways that an incident can be considered "material." This is true even where an incident responder might not have considered the incident "significant." That potential delta can be narrowed or closed without running afoul of the new disclosure rules by managing the affirmative representations your organization is making in its public filings and marketing statements.

2. **Understand the materiality implications of your organization's internal escalation processes.** These likely include escalation protocols that might actually use the term "material" or otherwise leverage proxies for materiality (for example, significant reputational harm, impact to a threshold number of accounts, disruption of operations for a certain amount of time). If, for example, your information security stack leverages incident severity labels such

as P0 – P5 alerts, it is important to engage experienced legal counsel to review such severity labels and assess how well they conform to a materiality assessment.

The next step is ensuring that the right resources and escalations are in place for a timely materiality assessment by the appropriate resources, in a manner that aligns to these classifications. This may mean not only reviewing your organization's incident severity framework, but also its incident response processes and relevant "RACI" charts identifying who is responsible, accountable, consulted, and informed of particular events.

3. **Understand how much your particular organization's business model implicates a greater reliance on good cybersecurity.** As noted above, materiality is all about the perspective of the reasonable investor. Setting aside any affirmative representations your organization may have made, it can be helpful to assess how unusually important cybersecurity is to your organization's business model. Because materiality is focused on the expectations of the reasonable investors, it can be helpful to assess whether there is reason for investors to have heightened expectations with respect to the security of your organization's network.

4. **Make sure that legal determinations are not being pushed down to your organization's technical staff.** Ask any securities lawyer what "materiality" means in the context of SEC disclosure requirements, and they will respond that information is material where there is substantial likelihood that a reasonable shareholder would consider it important in making an investment decision, or if it would have significantly altered the "total mix" of information made available. That articulation is not a standard technical folks should be expected to apply and should be translated to organizationally specific metrics that can act as a proxy for a potentially material event.

As noted in the guidance, organizations need to take a broad view as to what may be material. This means if an organization is doing things correctly, the company's legal resources assessing materiality may often assess many cyber incidents that end up not being material. If everything that they assess ends up being material, this is an indication that the organization's escalation processes are likely missing potentially material incidents for consideration.

Notes

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2. *https://www.sec.gov/files/rules/final/2023/33-11216.pdf.*
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CEO/CFO CERTIFICATIONS

Is It Time to Take a Fresh Look at Disclosure Controls for CEO/CFO Certifications?

By Randy Wang

In *New England Carpenters Guaranteed Annuity and Pension Funds v. DeCarlo* (Aug. 2023), the Second Circuit held, among other things, that CEO/CFO certifications mandated by SOX Section 302 constitute non-actionable statements of opinion.[1] As a result, the court affirmed the dismissal of Section 11 claims because the complaint failed to adequately allege the officers did not believe what they certified or that they did not engage in meaningful inquiry.

As discussed under "Takeaways" below, the decision—along with recent Securities and Exchange Commission (SEC) enforcement actions—provide an opportunity to refresh company disclosure controls and procedures that support officer certifications.[2]

Background of the Case

In 2017, a large P&C insurer restated its financial results due to two accounting errors. First, it recognized warranty contract revenue at the time of sale instead of deferring that revenue over the life of the contract. Second, it expensed discretionary employee bonuses in the year paid instead of accruing that expense in the year earned.

After the restatement and the stock price fell, investors sued the company, its officers and directors, its former auditor and underwriters under Sections 11, 12, and 15 of the Securities Act, Section 10(b) and 20(a) of the Exchange Act and Rule 10b-5.

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The district court dismissed the complaint, holding that the company's financial statements reflected the exercise of subjective judgment and were therefore non-actionable statements of opinion.

The Second Circuit affirmed the dismissal of most of the claims, but disagreed with the application of the Supreme Court's *Omnicare* decision to Section 11 claims against the company and its officers and directors based on improper accounting. The court stated:

> Opinions are thus actionable . . . not only when "the speaker did not hold the belief she professed," but also if the statement of opinion contains embedded statements of fact that are untrue, or the statement omits information whose omission conveys false facts about the speaker's basis for holding that view and makes the opinion statement misleading to a reasonable investor. [citations omitted].

The court found that plaintiffs' adequately alleged the lack of any basis for the company's accounting treatment for extend warranty contract revenue, thereby rebutting the company's argument that it was permitted to exercise subjective judgment under GAAP. Likewise, it found they plausibly alleged the company's deferral of compensation expense until paid was objectively improper rather than an exercise of subjective judgment.

In the case of the SOX certifications, however, the court agreed that those were non-actionable statements of opinion. With respect to the company's financial reporting, it noted the certifications explicitly state they are "based on [the] knowledge" of the officer. With respect to disclosure controls and procedures and internal control over financial reporting, the court found that they "contain language that conveys management's subjective judgments about the company's internal controls and thus constitute statements of opinion." Further, the court held that the complaint failed to adequately allege the officers did not believe what they certified or that they did not engage in meaningful inquiry.

Takeaways

The *New England Carpenters* decision should provide some comfort to certifying officers that liability will not automatically result from a disclosure failure. However, companies should continue to follow "best practices" and document their disclosure controls and procedures (DCPs) to support their filings, including officer certifications. Rule 13a-15 requires that SEC registrants maintain DCPs designed to ensure that information required to be disclosed by the company in its Exchange Act reports is timely recorded, processed, summarized and reported. Recent enforcement actions makes clear that the SEC is prepared to sanction companies that fail to maintain sufficient controls and procedures, even in the absence of disclosure deficiencies.[3]

Even if companies are comfortable with their current practices, consideration could be given to adding steps from the following list to further enhance their DCPs:

- Establishing a disclosure committee to oversee a systematic approach to collecting and reviewing required information for Exchange Act reports.
  - Document the composition and governance of the committee and its responsibility for considering the materiality of information and the timing of disclosure.
  - Each member of the committee should review and comment on the various drafts of the report. An appropriate record of meetings held by the committee, and the review of drafts by members, should be documented.
  - Prior to signing a certification, the CEO and CFO should review the relevant report and certifications. They should also meet with the disclosure committee and review the steps and procedures taken, and discuss any issues that have arisen and how they were resolved.
- Utilizing questionnaires or formal inquiries relating to relevant business units and functional roles.
  - Consider addressing inquiries as to each of the required disclosure items, instead of simply marking up last year's form without fresh inquiry.
  - Institute procedures to confirm the absence of any material changes subsequent to the inquiry process but prior to filing the report.
- Updating lists to incorporate hot topics, such as descriptions of legal proceedings, cybersecurity, perquisites and related person transactions, high profile media stories affecting the company, and climate change.
- Document input from subordinates, including sub-certifications.
  - Taking into account the particular culture, many companies require certifications from junior officers with respect to their areas of responsibility.
  - To be most meaningful, these should be tailored to the specific individual and his or her role, and not merely repeat the required certification.
- Assemble an appropriate file created containing back-up and supporting documentation for each of the various statements made in the report.
  - Confirm the existence of a reasonable basis, and adequate underlying documentation, to support any forward-looking statements in the report.
  - Consider maintaining the file in a format readily able to be shared with underwriters' or lenders' counsel for diligence

purposes, subject to appropriate confidentiality disclaimers and redaction of privileged, proprietary, or other sensitive information.

- Collect and review press releases, board materials, and other sources of information for relevance and consistency.
- Provide adequate time for legal advisors and auditors to review and comment on drafts
  - Appropriately address any issues raised.
  - Consider whether and/or how to memorialize the resolution of yellow or red flags raised, recognizing that emails and related attachments can be discoverable, even if deleted.
- Provide appropriate time for the Audit Committee and other directors to allow for meaningful review and dialogue.
  - Prior to signing any certification, the CEO and CFO should meet with the Audit Committee to review the procedures involved in substantiating the certification, any issues raised, and any action taken in response to the issues, as well as any changes to any internal audit controls or procedures, as contemplated by the certification. The minutes of the Audit Committee should reflect that discussion.

Notes

1. *https://cases.justia.com/federal/appellate-courts/ca2/20-1643/20-1643-2023-08-23.pdf.*
2. *https://www.bclplaw.com/en-US/events-insights-news/sec-penalizes-company-with-good-disclosures-for-insufficient-controls-also-for-clause-in-agreements-that-may-discourage-potential-whistleblowing.html.*
3. *https://www.bclplaw.com/en-US/events-insights-news/sec-penalizes-company-with-good-disclosures-for-insufficient-controls-also-for-clause-in-agreements-that-may-discourage-potential-whistleblowing.html.*

AUDIT FEES

The Average Audit Fee Reached an All-Time High in 2022

By Dan Goelzer

In 2022, the average audit fees for Securities Exchange Commission (SEC)-registered public companies increased 11 percent over 2021 and hit an all-time high of $2.24 million. That is the headline finding of "20-Year Review of Audit Fee Trends 2003-2022," Ideagen Audit Analytics' (AA) annual analysis of fees paid to external auditors.[1]

Last year, AA reported that 2021 audits fees had increased over the prior year, but not to record levels. For S&P 500 companies, the average audit fee was $10.78 million, a record high for the S&P 500 and a 3 percent increase from FY2021.[2]

The highlights of AA's report and blog post are discussed below.

Total Audit Fees Increased

Total audit fees paid by SEC registered public companies (domestic and foreign) were $16.8 billion in FY2022, an increase of 0.6 percent over FY2021. Total audit fees paid by US companies (that is, excluding foreign registrants) in 2022 rose to $12.36 billion, up 0.7 percent from 2021. For the S&P 500, total audit fees reached an all-time high of $5.38 billion.

Dan Goelzer *is a retired partner of Baker McKenzie, a major international law firm. He advises a Big Four accounting firm on audit quality issues. From 2017 to July 2022, Dan was a member of the Sustainability Accounting Standards Board. The SEC appointed him to the Public Company Accounting Oversight Board as one of the founding members, and he served on the PCAOB from 2002 to 2012, including as Acting Chair from 2009 to 2011. From 1983 to 1990, he was General Counsel of the Securities and Exchange Commission.*

Total audit fees increased despite a 9 percent decline in the number of reporting companies (from 7,963 in FY2021 to 7,279 in FY2022. The drop in companies was largely the result of changes in the special purpose acquisition companies (SPAC) market. SPAC initial public offerings (IPOs) fell 86 percent between 2021 and 2022, and 35 percent of SPACs that reported fees in FY2021 did not file in FY2022.

Total Fees Paid to Auditors Fell

Although total audit fees rose, the total fees of all types that SEC registrants paid to their auditor decreased slightly. (Total fees include audit fees, audit-related fees, fees for tax services and fees for other services.) Total FY2022 fees were $20.2 billion, a decrease of less than 1 percent from FY2021. AA states that the decrease in total fees aligns with the decrease in the reporting company population in FY2022. Each category of non-audit fee saw a decrease from FY2021. Audit related fees decreased 8 percent, tax fees decreased 4 percent, and other fees decreased 15 percent.

The Average Audit Fee and the Average Total Payment to the Auditor Both Increased

As noted above, the average audit fee increased 11 percent from FY2022, reaching an all-time high of $2.24 million per SEC registrant. Average audit-related fees and average tax fees increased by 2 percent and 7 percent, respectively, while the average of other fees decreased by 6 percent in FY2022.

Overall, average total fees paid grew 10 percent to $2,702,922, a 20-year record.

Audit Fees Per $1 Million of Company Revenue Fell

Audit fees as a percentage of client revenue were $576 per $1 million of revenue in FY2022, a 6 percent decrease from FY2021 and a nine-year low. Although both audit fees and audit client revenue increased in FY2022, client revenue grew faster—revenue rose 8 percent from FY2021, compared to audit fee growth of only 0.6 percent. For the S&P 500, revenue increased 12 percent in FY2022, while audit fees paid rose by only 4 percent, resulting in audit fees per $1 million dollars of revenue dropping to $343.

For US-based companies, the average was $583 in audit fees per $1 million of revenue, down 8 percent from FY2021, while foreign SEC filers experienced a 2 percent decrease to $558 per $1 million of revenue. AA points out that SEC-registered foreign companies are, on average, larger than US-based public companies and that the Public Accounting Oversight Board's (PCAOB) focus on audits performed by non-US accounting firms may be affecting foreign company audit fees.

EisnerAmper had the highest audit fees per million dollars of client revenue, at $16,595; by comparison, PwC's audit fees averaged $616 per million of client revenue. (The difference in fee per million in client revenue is presumably a function of difference in average client size.)

The Average Audit Fee Rose for Larger Companies but Fell for Smaller

In FY 2022, average audit fees increased 7 percent (to $5.27 million) for large accelerated filers, the biggest public companies. For the next size tier, accelerated filers, average audit fees paid increased by a stunning 33 percent in FY2022 to $1,453,905. However, the smallest public companies, non-accelerated filers, experienced a modest decrease in average audit fees paid. In FY2022, the average non-accelerated audit fee was $616,706, down 1 percent from FY2021.

The Large Firms Dominate SEC Filer Auditing

The four largest accounting firms earned 92 percent of audit fees paid by SEC registrants in FY2022. PwC led with 28 percent of total audit fees ($4.66 billion). EY had a 25 percent share of total audit fees ($4.27 million), followed by DT at 23 percent ($3.81 billion), and KPMG at 16 percent ($2.74 billion).

Six firms audited the S&P 500—the four firms listed above, plus Grant Thornton and BDO. PwC had a 35.7 percent share of total S&P 500 audit fees.

There Was Little Change in the Industries with the Highest and Lowest Average Fees and Fees Per $1 Million of Revenue

The 2022 highest average audit fees were in Transportation ($3.016 million) and Finance ($2.676 million). The industries with the lowest average audit fees were Agriculture ($1.322 million) and Mining ($1.513 million). These same industries were at the top and bottom of the 2021 average fee list.

The industries with the highest audit fees per $1 million dollars of revenue in 2022 were Agriculture ($1,290 per million) and Finance ($1,016 per million). The industries with the lowest fees per $1 million dollars of revenue were Retail Trade ($168) and Wholesale Trade ($225).

Takeaways

Audit committees may find it useful to compare changes in their company's fees with the information in the AA report. AA points out in the Introduction to its 2022 report that "[a]udit fees paid to external auditors can be an indicator of audit complexity.

Analyzing fees provides further insights into audit risk and auditor independence."

Committees might also want to focus on how their non-audit fees compare to the broad metrics. As noted above, AA found that non-audit fees declined in 2022. AA observes that "much discussion has centered around the effect that significant non-audit services have on external auditors' level of independence" and that many countries (including the United States) restrict the type of non-audit services allowed or the amount auditors can be paid for non-audit services. Beyond regulatory restrictions, many audit committees limited their company's use of the financial statement auditor for non-audit services to avoid questions about the possible impact of such services on auditor objectivity.

Notes

1. *https://go.auditanalytics.com/AuditFeesReport2023?utm_source=website&utm_medium=blog&utm_campaign=2023.08.15*.
2. *See* Audit Fee Trends of S&P 500, an AA blog post which breaks out the findings of the annual study for the S&P 500 at *https://blog.auditanalytics.com/audit-fee-trends-of-sp-500/*.

DEFINITION OF SECURITIES

Second Circuit Holds That Syndicated Term Loans Are Not Securities

By Parvin Daphne Moyne, Michael Asaro, Peter Altman, Jesse Brush, Daniel Fisher, and Brian Daly

In 2017, the trustee of the Millennium Lender Claim Trust brought an action in New York state court against a syndicate of lenders alleging that a $1.8 billion syndicated loan transaction violated, *inter alia*, state securities laws. The defendants removed the case to federal court and then moved to dismiss on the basis that the Millennium syndicated loan notes (Notes) are not securities under the "family resemblance test" articulated in *Reves v. Ernst & Young.*[1]

In *Reves*, the Supreme Court recognized that a presumption exists that notes are securities. *Reves* then directs courts to uncover whether the note was issued in an "investment context" (and is thus a security) or in a "consumer or commercial context" (and is thus not a security). The Supreme Court directed courts to determine whether the particular notes bear a "family resemblance" to securities or non-securities.

The four factors of the "family resemblance test" are: (1) "the motivations that would prompt a reasonable seller and buyer to enter into [the transaction];" (2) "the plan of distribution of the instrument;" (3) "the reasonable expectations of the investing public;" and (4) "whether some factor such as the existence of another regulatory scheme [significantly reduces] the risk of the instrument, thereby rendering application of the Securities Act unnecessary."

Parvin Daphne Moyne, **Michael Asaro**, **Peter Altman**, **Jesse Brush**, **Daniel Fisher**, *and* **Brian Daly** *are attorneys of Akin Gump Strauss Hauer & Feld LLP.*

On May 22, 2020, Judge Paul G. Gardephe of the US District Court for the Southern District of New York granted the defendants' motion to dismiss, holding that the Notes were analogous to bank loans—not securities. On October 28, 2021, the plaintiff appealed to the US Court of Appeals for the Second Circuit,[2] and the case was argued on March 9, 2023. Shortly after oral argument, on March 16, 2023, the Second Circuit solicited the Securities and Exchange Commission's opinion regarding whether a syndicated term loan note is a security. The Commission sought three extensions of time to file its *amicus* brief before ultimately informing the court that it was not in a position to provide its views on the issue.

The Second Circuit Decision

On August 24, 2023, in a unanimous opinion authored by Judge José A. Cabranes, the Second Circuit affirmed the lower court's dismissal. In applying the "family resemblance test," the Second Circuit found that three of the four factors weighed against finding that the plaintiff had adequately alleged that the Notes constituted securities under *Reves*.

Factor 1—Motivations

In assessing the first *Reves* factor, the court held it "must determine 'whether the motivations [of the seller and buyer] are investment (suggesting a security) or commercial or consumer (suggesting a non-security).'" The court found that the parties' motivations were mixed. On one hand, the lenders' motivation was "investment" because they expected to profit from the Notes.

On the other hand, the borrower's motivation was "commercial" because it planned to use the Note proceeds to pay down existing debt; make a shareholder distribution; redeem or repay outstanding warrants, debentures and stock options; and pay fees and expenses related to issuing the Notes. Altogether, the court concluded that the plaintiff had plausibly alleged the Notes constituted securities under the first factor.

Factor 2—Distribution

In assessing the second *Reves* factor, the court "examine[d] the plan of distribution of the instrument to determine whether it is an instrument in which there is common trading for speculation or investment." The court focused on the fact that the Notes were unavailable to the general public, in particular highlighting the importance of limitations on the distribution of the Notes to a "natural person" or without the consent of the issuer and the administrative agent.

The Notes could not be assigned to natural persons or without the consent of the borrower and administrative agent. The credit agreement also included restrictions on transfers in amounts less than $1 million. Notably, the court rejected plaintiff's argument that the presence of a secondary market was dispositive given these assignment restrictions.[3] The second factor thus weighed against finding that the plaintiff had plausibly alleged that the Notes constituted securities.

Factor 3—Expectations

In assessing the third *Reves* factor, the court explained that "[i]f buyers were 'given ample notice that the instruments were . . . loans and not investments in a business enterprise,' it suggests that the instruments are not securities." The court found that this factor also weighed against concluding that the Notes constituted securities because, in the documents governing the Notes, the lenders had to certify that they were sophisticated and experienced in extending credit and that they had made an independent appraisal of the loans without reliance on any agent or borrower.

The court was not persuaded by the intermittent references in the loan documents to the buyers (that is, the lenders) as "investors," finding that "[t]hese isolated references could not have plausibly created the *reasonable* expectation that the buyers were investing in securities."

Factor 4—Other Regulatory Factor(s)

In assessing the fourth factor, the court "examine[d] whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." The court concluded that the fact that the Notes were secured by collateral and that federal regulators had issued specific policy guidance addressing syndicated loans further weighed against concluding that the Notes are securities. The court was not persuaded by arguments that these guidelines were meant to minimize risks to banks, finding that "in doing so it also aims to protect consumers."

Implications

Had the Second Circuit held that syndicated term loans are securities, it would have disrupted decades of market conventions in the syndicated loan market. Moreover, a contrary decision from the Second Circuit could have exposed commercial lenders, secondary market participants, and borrowers to increased risk of liability for insider trading and tender offer requirements, and would have significantly restricted existing CLOs from owning syndicated term loans.

In short, there would have been significant chaos in the loan markets. The Second Circuit's decision should assuage these immediate concerns and provide further guidance to lenders and borrowers seeking to minimize the risk of having loans classified as securities in the future.

Notes

1. *Reves v. Ernst & Young*, 494 U.S. 56 (1990).
2. Plaintiff also appealed the district court's ruling that it had subject matter jurisdiction pursuant to the Edge Act, 12 U.S.C. § 632. The Second Circuit held that the district court properly concluded that it had jurisdiction. See our prior client alert on this topic at *https://www.akingump.com/en/insights/alerts/second-circuit-considers-whether-syndicated-term-loans-are-securities*.
3. In so finding, the court found that the Notes contained restrictions on assignments similar to those placed on the loan participations at issue in *Banco Espanol de Credito v. Security Pacific National Bank,* 973 F.2d 51 (2d Cir. 1992). There, the Second Circuit found the limitations placed on the reselling of the loan participations without express written permission of the issuer weighed against the conclusion that the loan participations were securities. *Id.* at 55.

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